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Article

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# Rethinking financial regulation: an appraisal of regulatory approaches in the UK and EU\*

*Deepa G Driver\*\* and Andrea Miglionico\*\*\**

## ABSTRACT

This article explores different regulatory approaches that have shaped regulation in the run-up to and aftermath of the 2007-09 global financial crisis. In doing so it seeks to clarify and cast fresh light upon the shifting regulatory and practitioner discourse. This in turn is intended to aid reflection on how these approaches might best be adopted, adapted or synchronised to achieve the aims of financial regulation. The first part of this article examines the approaches from a theoretical perspective, discussing their strengths and weaknesses. The second part of the article analyses regulation in practice, focussing primarily on rules-based regulation and principles-based regulation. As a practical example, the article looks at the MiFID directive – a cornerstone of securities regulation – within the EU and UK jurisdictional context. The article concludes with observations and comments on how these approaches might best be coordinated to achieve the broader regulatory agenda.

**SUMMARY:** 1. Introduction. – 2. A review of rules-based regulation and principles-based regulation. – 3. Risk-based, outcomes-oriented and judgement based regulation: the current trends in the UK financial markets. 4. The EU regulatory strategy for the securities market. – 5. The UK and Continental securities regulation: in search of a possible link. – 6. Accountable regulation of market participants and investor protection. – 7. Concluding remarks.

**Key words:** investor protection, stakeholders, financial regulation, principles-based regime, rules-based regulation, risk-based regulation, judgement-based regulation, disclosure-based regulation, merit-based regulation, compliance function, outcomes-oriented regulation and risk management.

1. Financial markets provide the venue (real or virtual) and mechanisms for societal coordination by allowing buyers, sellers and intermediaries to value, transform and transfer resources. Their purpose – in the main – is to help bridge societal preferences in relation to maturity, liquidity, size and risk. Viewed holistically, and in the context of the satisfaction of societal needs, it is envisaged that well-functioning financial markets can be used where appropriate to allocate resources and risk in a transparent and competitive<sup>1</sup> manner, facilitating economic development and progress within socially agreed boundaries<sup>2</sup> to both

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\* This article is a result of joint collaboration. Sections 1, 2 and 3 have been written by D.G Driver. Sections 4, 5 and 6 have been written by A. Miglionico. Section 7 presents shared reflections on the subject matter.

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<sup>1</sup> Competition may not be considered the most appropriate remedy for natural monopolies for example. In such circumstances, it would not be appropriate to pursue higher levels of competition just as an end in itself.

<sup>2</sup> D. Campbell and S. Picciotto, 'Exploring the interaction between law and economics: the limits of formalism'

the applicability of marketisation<sup>3</sup> and its limitations.<sup>4</sup>

Faith in the sustainability and integrity of financial markets is of importance in societies that wish to largely rely upon market-based allocation of financial resources and risks in the long run. Such trust, in turn cements the role of markets as the primary choice of social institution used for resource allocation. Financial regulation serves as a community safeguard to proactively ensure safety, soundness and appropriate behaviour in financial markets. Given the inherent fragility entailed by the transformative activities undertaken in financial markets, it would be naïve not to recognise that institutional collapse or misbehaviour by financial intermediaries can have far-reaching societal consequences that are not easily remedied. As Beltran observes “the costs of preventive actions are usually tangible, clearly allocated and often short term, whereas the costs of failing to act are less tangible, less clearly distributed and usually longer term”.<sup>5</sup>

The importance of financial regulation must not therefore be underestimated. It is also important to recognize at the outset that financial regulation, in its role protecting the interests of societal stakeholders at large, is therefore imbued with both a socio-political purpose (such as protecting the interests of future generations or distributive justice) and an economic imperative (typically discussed within the welfare economics approaches to market failure).<sup>6</sup>

In the above context, this article sets out the thinking behind seven key regulatory approaches that have impacted financial regulation (particularly in the EU and the UK) in the run-up to and aftermath of the global financial crisis of 2007 (the GFC). These approaches are: rules-based regulation, principles-based regulation, outcomes-oriented regulation, risk-based regulation, judgement-based regulation, disclosure-based regulation and merit-based regulation. Our aim is to clarify and cast fresh light upon the weaknesses in the regulatory and practitioner discourse<sup>7</sup> and to corral a range of ideas so as to add depth to the discussion and allow for more critical reflection on whether these approaches might best be adopted or synchronised to better achieve the purpose of regulation.

In reviewing these materials, our analysis takes into consideration the evidence-based

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(1998) 18(3) *Legal Studies*, 249-250.

<sup>3</sup> A market-based solution may not be the optimal way to allocate resources in certain circumstances. For example, we may find that a market in child labourers or human body parts may not necessarily be desirable.

<sup>4</sup> Implicit here is the view that not everything can and/or should be valued through markets. See Sandel, *What Money Can't Buy: The Moral Limits of Markets*, Allen Lane, United Kingdom, 2012.

<sup>5</sup> J. Beltran, ‘Late lessons from early warnings: the precautionary principle 1896–2000’, Environmental Report No 22, European Environmental Agency, Copenhagen, 2001 at [http://www.eea.europa.eu/publications/environmental\\_issue\\_report\\_2001\\_22](http://www.eea.europa.eu/publications/environmental_issue_report_2001_22).

<sup>6</sup> D.G. Driver, *Governance, Financial, Regulation, Risk and Compliance: An Integrated Approach* (John Wiley and Sons, forthcoming).

<sup>7</sup> E. Engelen, I. Erturk, J. Froud, S. Johal, A. Leaver, M. Moran, A. Nilsson and K. Williams, *After the Great Complacency: Financial Crisis and the Politics of Reform* (Oxford University Press, 2011).

study presented by Di Lorenzo who rightly points out that “the public policy debate regarding the preference for principles-based or rules-based regulatory structures to achieve legislative congruence ignores the important role, often determinative role, of government enforcement measures”<sup>8</sup>. We are cognisant of an inherent bias when the predominant assumption within the supporting literature is of requiring regulatory efficiency and effectiveness and the acceptability of a non-zero failure regime rather than a more comprehensive safety culture.<sup>9</sup> There is also an assumption that greater efficiency equates to lower costs and bureaucracy for the regulated community while a broader view of efficiency in terms of medium to long term social outcomes is typically underplayed in such discussions.

2. Rules-based regulation is a cornerstone of financial regulation in many jurisdictions including the US<sup>10</sup> and the UK. Detailed rules are viewed as providing a prescriptive, specific, concrete, procedural, and particular way of articulating regulatory requirements<sup>11</sup>. Generally, rules-based regulation is based on the provision and communication of such detailed requirements, and is intended to clarify regulatory expectations and set behavioural boundaries ex-ante. It is therefore purported to increase certainty for regulated entities, regulators and stakeholders. Specificity obviates the need for specialist interpretation of requirements. This, in turn, serves to reduce the cost and improve the ease of compliance for regulated entities (in particular for small firms that may have limited specialist compliance resource). However, on account of this same ex-ante nature, regulation composed of detailed rules may be over-inclusive or under-inclusive<sup>12</sup>.

If rules are specific (as intended), then, in rapidly evolving markets such as finance, regulation may require frequent revision to keep up with the pace of change. This requires the expense of scarce time and resource, causing regulators to constantly fall behind market practice. By their very nature, rules may also be intransigent, providing both regulated entities and regulators with lesser choice in interpretation and in turn result in poor outcomes for both, in circumstances that where greater flexibility is deemed to be valuable. A more command

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<sup>8</sup> V. Di Lorenzo, ‘Principles-based regulation and legislative congruence’ (2012) 15(1) *New York University Journal of Legislation and Public Policy*.

<sup>9</sup> R. Paul and M. Huber, ‘Risk-based Regulation in Continental Europe?’, HowSAFE Working Paper No 2, February, 2015.

<sup>10</sup> J. Black., ‘Paradoxes and Failures: ‘New Governance’ Techniques and the Financial Crisis’ (2012) 75(6) *The Modern Law Review*, 1037-1038.

<sup>11</sup> B. Burgemeestre, J. Hulstijn and Y. Tan, ‘Rules-based versus Principle-based regulatory compliance’, Conference Paper presented at JURIX 2009: The Twenty-Second Annual Conference on Legal Knowledge and Information Systems, 2009.

<sup>12</sup> J. Black, M. Hopper and C. Band, ‘Making a Success of Principles-based Regulation’ (2007) *Law and Financial Markets Review*, 191-192.

and control, structure is often required for the promulgation of rules<sup>13</sup>, denuding participatory ownership within the regulated community, notwithstanding any lobbying or regulatory capture that might accompany such regulation and influence or subvert rule-making in the first place. For many regulated entities, ~~a~~-this command-and-control approach to enforcing compliance with detailed rules may also engender a tick-box mindset aimed at meeting the ‘letter of the law’<sup>14</sup>. As Frantz and Instefjord point out “the regulator must forward engineer the implications of compliance for the intended regulatory outcomes”<sup>15</sup>. Not only does this place an onus upon the regulator to prescribe the acceptable ‘hows’, it attracts criticism for resultantly excluding the possibility of alternative, potentially more effective processes undermining even those regulatees who might be able to devise more effective methods for meeting regulatory objectives. Worse still, rules-based regulation could be more easily subject to gaming through ‘creative compliance’<sup>16</sup> and the misuse of legal and financial engineering<sup>17</sup> that are aimed at undermining or circumventing rules, complying with the letter of regulation while ignoring its spirit.

Principles, may be understood to be more ‘generalised rules’ or ‘bright-line rules’.<sup>18</sup> They offer a higher-level, normative, broad-brush and more abstract specification of regulatory requirements.<sup>19</sup> Principles should therefore typically offer greater room to accommodate and interpret regulation taking into account the nuances of specific circumstances, thus facilitating the use of discretion when one size does not necessarily fit all. Both regulated entities and regulators may also more effectively apply reasoning to arriving at the right outcome.

The locus of ownership in complying with requirements is moved to the regulated entity through the opportunity to exercise greater judgement, thus purportedly allowing greater autonomy to market participants in outlining both business strategy and acceptable modes of compliance with regulation. There is however a trade-off with certainty, particularly when judging compliance or enforcing against non-compliance ex-post, given that the regulator’s judgement may differ from those of the regulated entity. They may engender greater

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<sup>13</sup> J. Black, *Rules and Regulators* (Clarendon Press, Oxford, 1997).

<sup>14</sup> J. Black, M. Hopper and C. Band (note 12).

<sup>15</sup> P. Frantz and N. Instefjord, ‘Rules vs Principles-based financial regulation’, Working paper, 2014 at <http://ssrn.com/abstract=2561370>.

<sup>16</sup> D. McBarnet, ‘When compliance is not the solution but the problem: Changes in law to changes in attitude’, Australian National University, Centre for Tax System Integrity, Working Paper No 18, August 2001 at <http://citeseerx.ist.psu.edu/viewdoc/download;jsessionid=5429976649F494B435383854C37BF93D?doi=10.1.1.201.8934&rep=rep1&type=pdf>.

<sup>17</sup> D. McBarnett, ‘Financial Engineering or Legal Engineering? Legal Work, Legal Integrity and the Banking Crisis’ in I. MacNeil and J. O’Brien (eds), *The Future of Financial Regulation* (Hart, Portland, 2010).

<sup>18</sup> C. Ford, ‘Principles-based securities regulation in the wake of the global financial crisis’ (2010) 55 *McGill Law Journal*, 257-258.

<sup>19</sup> B. Burgemeestre, J. Hulstijn and Y. Tan (note 11).

uncertainty through the variety inherent in the interpretation of principles, and therefore principles may be more difficult to enforce.

Principles may also be seen to facilitate ex-post re-examinations which may hold regulated entities up to differing standards than originally expected, due to the potential for a change in the thresholds against which interpretation of requirements might be carried out. Schwarz suggests that “unless protected by a regime enabling one in good faith to exercise judgment without fear of liability, such a person will effectively act as if subject to a rule and, even worse, an unintended rule”<sup>20</sup>. A corollary to this is offered by Sants who noted that “a principles-based approach does not work with individuals who have no principles”<sup>21</sup>. It is also worth bearing in mind that principles may require greater interpretation for appropriate application to circumstances, resulting in increased need for compliance expertise and associated costs. Like rules, subject to the quality of regulation, principles could also be gamed by those who chose to circumvent regulation – again the key to this lies in how the principles are applied and how enforcement action is taken for non-compliance.

There are some topics that lend themselves to detailed rules and others where a principle may set out the regulatory requirement more clearly. For example, when regulators set requirements for the disclosure documents on mortgage offers, they might require by rule the disclosure of certain pieces of information that consumers might legitimately require in order to make rational comparisons. In such situations, a specific rule might be appropriate. In other circumstances, a principle such as requiring firms to ensure that all information provided to consumers is not misleading might better suit the desired outcome.

~~It is also worth remembering that~~Perhaps, as a result of this realisation, in practice, principles-based regulation – although deemed to be more sophisticated – ~~does not imply~~has not meant that principles alone are used to communicate regulation or that they alone exist in practice to the exclusion of rules or a rulebook. For example, financial conduct regulation in the UK is deemed to be conducted in a principles-based manner, but a detailed rulebook also does co-exist supplementing high-level principles with detailed rules. This appears to be the case more generally at other Anglo-Saxon regulators who adopt principles-based regimes. Ford reminds us that the difference between rules-based regimes and principles-based regulation is not merely in opting for one drafting format rather than the other<sup>22</sup>. Importantly

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<sup>20</sup> S.L. Schwarcz, ‘The “Principles” Paradox’, Duke Law School Legal Studies Paper No 205, 2008.

<sup>21</sup> See ‘The Turner Review. A regulatory response to the global banking crisis’, March 2009, 86-87.

<sup>22</sup> C. Ford, ‘Principles-based Securities Regulation: A Research Study prepared for the Expert Panel on Securities Regulation at <http://www.expertpanel.ca/documents/research-studies/Principles%20Based%20Securities%20Regulation%20-%20Ford.English.pdf>. The author pertinently notes that “whether a regulatory system fosters clarity and predictability, for example, is not entirely related to

what varies between principles-based and rules based regimes is how regulators are expected to implement regulation – from the drafting of policy rules through to supervision and enforcement.

3. Although the five other approaches to regulation detailed within this article carry their own headlines and have independent standing in regulatory practitioner literature, in practice, regulation using these approaches when articulated typically takes the drafted form of detailed rules or high level principles<sup>23</sup>.

Risk-based regulation is the most widely used and accepted amongst these, and is recommended for adoption by international bodies including the OECD and the British government across a range of industries from finance to healthcare. It relates to the prioritisation of regulatory resources in both the functioning of the regulator as an institution and in the application of regulatory requirements (whether rules or principles) to regulated entities.

The OECD defines risk-based regulation as follows: “a risk-based approach to regulation explicitly acknowledges that the government cannot regulate to remove all risks and that regulatory action, when taken, should be proportionate, targeted and based on an assessment of the nature and the magnitude of the risks and of the likelihood that regulation will be successful in achieving its aims”<sup>24</sup>. Accordingly, regulators are required to allocate their resources to problems which are deemed to carry the highest risks as are regulated entities. It has been noted that “rather than trying to prevent all possible harms, risk-based approaches promise to rationalise and manage the inevitable limits of what regulation can hope to achieve by focusing regulatory standard-setting and enforcement activity on the highest priority risks, as determined through formal assessments of their probability and consequences”<sup>25</sup>.

In parallel, regulated entities are expected to prioritise those risks which are deemed to be greatest. This approach to regulation came into prominence in the UK in the 1980s and 90s with the emergence of what Hutter refers to as the ‘deregulatory rhetoric’<sup>26</sup> with its emphasis

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whether it is rules-based or principles-based. The real question is whether regulator and regulatees have a shared understanding of what the regulations entail poor implementation can produce a system that is less transparent, less predictable, and less fair.”

<sup>23</sup> Other formats such as standards or codes of practice may also be used but in the jurisdictions related to this article, rules and principles form the predominant bulk of formal communication by regulators.

<sup>24</sup> OECD, Risk and Regulatory Policy: Improving the Governance of Risk, OECD Publishing, Paris, 2010 at [http://www.keepeek.com/Digital-Asset-Management/oecd/governance/risk-and-regulatory-policy\\_9789264082939-en#page1](http://www.keepeek.com/Digital-Asset-Management/oecd/governance/risk-and-regulatory-policy_9789264082939-en#page1).

<sup>25</sup> A. Beaussier and D. Demeritt, et al, ‘Accounting for failure: risk-based regulation and the problems of ensuring healthcare quality in the NHS’ (2016) 18(3-4) *Health, Risk and Society*, 2016.

<sup>26</sup> B. Hutter, ‘The attraction of risk-based ideas in regulation: accounting for the emergence of risk ideas in regulation’, London School of Economics Centre for Analysis of Risk and Regulation, Discussion paper No 33,



on regulatory accountability<sup>27</sup> and economy in regulatory resource usage and associated regulatory costs, reduction of the regulatory burden on firms and the cost of compliance<sup>28</sup> as well as a philosophical bias towards adopting more private sector practices and styles in regulation.

In Anglo-Saxon jurisdictions, such rationality has been predicated on some form of formal risk assessment coupled with attendant prioritisation, which is typically focused on regulatory efficiency. It has been argued that “risk has become a central means for making regulation socially optimal by using formal risk assessments of probability and consequence both to define regulatory objectives as well as target only the greatest threats to achieving those objectives”<sup>29</sup>.

There are three key weaknesses of this regulatory approach. The first is that these risk-based regimes can be underpinned by a very simplistic evaluation of “risk to what”<sup>28</sup>. Efficiency increases through risk evaluations can tend to be simplistically equated to a reduction in regulatory costs or the reduction in costs or bureaucracy for regulated entities rather than a broader regard for systemic safety and consumer protection or the pursuance of stakeholder interests in the medium to long term. There is also the concern that the “risk-to-what” question can elicit very different answers based on the motivations and incentives<sup>29</sup> of regulators and regulatees creating greater fuzziness in the interpretation of regulatory principles.

Secondly, risk-based prioritisation requires the agreement of stakeholders in the acceptable negative outcomes. It is worth reflecting on the underlying point made by Sir Donald Irvine who noted about risk-based regulation in a medical context that it “(...) is not compatible with the concept of a guarantee to the public of a good doctor for all (...) need to demonstrate that it has the public’s fully informed consent if it decides to support this line. After all it is patients, not doctors, who may be killed or injured by poor doctoring”<sup>30</sup>. Thirdly, there is an expectation that a ‘scientific’ risk-based approach creates a high degree of certainty<sup>31</sup>— whereas in reality, even with highly sophisticated models, “the real-world market is far richer in attributes and causal complexity than any model or collection of models is able to capture”<sup>32</sup>. This does not imply that more scientific approaches to assessing and addressing

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March 2005 at <https://www.lse.ac.uk/accounting/CARR/pdf/DPs/Disspaper33.pdf>.

<sup>27</sup> A. Beaussier and D. Demeritt, et al (note 25).

<sup>28</sup> Ibid.

<sup>29</sup> L. Bebchuk and H. Spamann, ‘Regulating Bankers’ Pay’ (2010) *Georgetown Law Journal*, 247-248.

<sup>30</sup> [http://webarchive.nationalarchives.gov.uk/20130107105354/http://www.dh.gov.uk/prod\\_consum\\_dh/groups/dh\\_digitalassets/@dh/@en/documents/digitalasset/dh\\_4132991.pdf](http://webarchive.nationalarchives.gov.uk/20130107105354/http://www.dh.gov.uk/prod_consum_dh/groups/dh_digitalassets/@dh/@en/documents/digitalasset/dh_4132991.pdf).

<sup>31</sup> D. McCloskey and S. Ziliak, *The Cult of Statistical Significance*, University of Michigan, 2008.

<sup>32</sup> Department of Social and Moral Philosophy, University of Helsinki, Purpose and Vision section of ‘The

risk should be eschewed, ~~but rather we suggest that what is~~ important is not to over-rely<sup>33</sup> on the sophistication of risk-based prioritisation, or to be blinded by the belief that it is always completely accurate in the selection of risks.

Disclosure-based regulation (which has been evident in the securities market) is characterized by the premise of ‘caveat emptor’ or ‘buyer beware’. The emphasis within regulation here, is to ensure that regulated entities provide sufficient information to investors, consumers and stakeholders, so that the other party can make a rational choice without any paternalistic regulatory interference. Typically, disclosure-based regulation tends to be allied to a more rules-based approach to regulation, although this is not always the case.

The challenges with the disclosure-based approach lie not just in setting the quality, frequency, and depth of disclosure, but in how recipients of information may process or address information disclosed to them<sup>34</sup>. ~~Where~~ Firstly, where gross information asymmetries exist between stakeholders, investors, consumers and the regulated entity, these may be an unfair onus placed on the presumed rationality of the information recipient (that may be exploited) causing detriment<sup>35</sup>. Cases from the crisis of 2007 related to the sale of sub-prime mortgages are an important case in point<sup>36</sup>. Secondly, recipients of information may be subject to various biases and heuristics, which may impede their rationality and which may be preyed upon by sophisticated marketers<sup>37</sup>. Thirdly, there is a presumption that those receiving the information are able and willing to act on behalf of all affected stakeholders. Scholars such as Villiers suggest that there is a misguided reliance on the role of corporate governance and responsible investors<sup>38</sup> who may neither be willing nor able to act as gatekeepers to the market.

Merit-based regulation requires regulated entities to allow the regulator to assess the merits and demerits of products and services that are introduced to the financial markets. The aim is to ensure a certain minimum quality rather than assure a consistent high quality in such offerings. Such merit-based regulation may take the form of pre-approval of new products,

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Market and Marketization: Models, Mechanisms and Explanation’, at <http://www.helsinki.fi/market/purposeandvision.htm>

<sup>33</sup> L. Elliott and D. Atkinson, *The Gods That Failed: How Blind Faith in Markets Has Cost Us Our Future*, Nation Books, New York, 2009.

<sup>34</sup> E. Avgouleas, ‘What future for disclosure as a regulatory technique? Lessons from behavioural decision theory and the global financial crisis’ in I. MacNeil and J. O’Brien, (eds), *The Future of Financial Regulation*, (Hart, Portland, 2010).

<sup>35</sup> J. Crotty, ‘Structural causes of the global financial crisis: a critical assessment of the ‘new financial architecture’ (2009) 33 *Cambridge Journal of Economics*, 563-564.

<sup>36</sup> L. Kotlikoff, *Jimmy Stewart is Dead: Ending the World’s Ongoing Financial Plague with Limited Purpose Banking* (John Wiley and Sons, 2011).

<sup>37</sup> J. Crotty (note 35).

<sup>38</sup> C. Villiers, ‘Has the financial crisis revealed the concept of the responsible owner to be a myth?’ in I. MacNeil and J. O’Brien (eds), *The Future of Financial Regulation* (Hart, Portland, 2010).

licensing of certain activities and so on. Merit-based regulation is deemed to increase fairness, justice and equity as it seeks to address challenges arising from informational imbalances, complexity and conflicts of interest by proactively ensuring the quality of offering within the financial markets.

Merit-based regulation is therefore a counter-point to more ‘laissez faire’ approaches to regulation and has attracted criticism<sup>39</sup> on the grounds that it restricts financial freedoms and that regulators are being presumptuous in assuming they possess the skill and knowledge to make assessments of suitability on behalf of all investors. Additionally, there is a cost-implication to the devotion of regulatory resources to such activities, which is often considered unjustified.

~~As mentioned, s~~Such costs are generally evaluated in terms of the regulatory burden to industry, rather than the wider societal consequences of introducing products which fail minimal tests for fairness and safety<sup>40</sup>.

A judgement-based approach to regulation is consistent with a more principles-based approach to regulation as it affords regulators the possibility of asserting their own judgement (typically evidence-based) to identify and address risks and challenge business models<sup>41</sup>. Its strengths and weakness are fairly similar to those of the principles-based approach more generally and its nomenclature has achieved prominence in the UK in the aftermath of the GFC<sup>42</sup>. It is worth pointing out that prior to the crisis regulators did exercise judgement while applying principles and rules; however the focus on regulatory judgements now appears to highlight the increased emphasis on regulatory skill, expertise and active regulatory intervention / non-intervention that is meant to accompany UK financial regulation more recently.

~~A judgement based approach to regulation is consistent with a more principles based approach to regulation as it affords regulators the possibility of asserting their own judgement (typically evidence based) to identify and address risks and challenge business models<sup>43</sup>. Its nomenclature has achieved prominence in the UK in the aftermath of the GFC<sup>44</sup>. This is of~~

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<sup>39</sup> R. Columbo, ‘Merit Regulation via the Suitability Rules’ (2013) 12(1) *Journal of International Business Law*.

<sup>40</sup> D.G. Driver (note 6).

<sup>41</sup> H M Treasury, ‘A new approach to financial regulation: judgement, focus and stability’ (July 2010) at [https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/81389/consult\\_financial\\_regulation\\_condoc.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/81389/consult_financial_regulation_condoc.pdf).

<sup>42</sup> Prudential Regulation Authority, ‘The Prudential Regulation Authority’s approach to banking supervision’, (April 2013) at <http://www.bankofengland.co.uk/publications/Documents/praapproach/bankingappr1304.pdf>.

<sup>43</sup> H M Treasury, ‘A new approach to financial regulation: judgement, focus and stability’ (July 2010) at [https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/81389/consult\\_financial\\_regulation\\_condoc.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/81389/consult_financial_regulation_condoc.pdf).

<sup>44</sup> Prudential Regulation Authority, ‘The Prudential Regulation Authority’s approach to banking supervision’, (April 2013) at <http://www.bankofengland.co.uk/publications/Documents/praapproach/bankingappr1304.pdf>.

~~course not to say that prior to the crisis regulators did not exercise a judgement-based approach.~~

Outcomes-oriented regulation is posited by regulatory practitioners as a corollary to principles-based regulation in that it seeks to structure regulatory attention around the broader achievement of regulatory outcomes as opposed to focussing upon the procedural steps that need to be followed by the regulated entity. While this may lead to a better appreciation of big-picture, longer-term considerations by both regulated entities and regulators, more nuanced shorter-term detriment might be neglected in the pursuance of the broader outcome. This approach to drafting principles and rules assumes that regulators understand the range of potential outcomes – both positive and adverse.

Outcomes-orientation is intended to encourage a broader-perspective on results for society and consumers. Rather than focussing on interim outputs (e.g. satisfaction scores), the aim is to focus on what the overall outcome (e.g. has the customer been treated fairly?). Given that outcomes are at a high level it is a challenge for both regulators and regulated entities to operationalise how they will be achieved or assessed. Management information in turn is often difficult to define, obtain and assess, making it difficult for regulators to offer substantive evidence-based challenge. In larger or complex regulated firms, achievement of outcomes may arise from a multiplicity of functional areas; this makes accountability difficult to establish and also makes it harder for regulators to take targeted enforcement or supervisory actions. Organisational embedding of an outcomes-orientation is challenging, both within regulators and within regulated entities, because cultural changes to encourage big-picture thinking can be difficult to establish. A good example of this lies in descriptions of the early challenges experienced by the former UK regulator, the FSA, in establishing the ‘Treating Customers Fairly’ agenda in the UK<sup>45</sup>. Many of these problems are linked to ~~and are~~ very similar to the broader challenges of adopting a principles-based approach to regulation.

Reliance is placed on regulated entities to demonstrate integrity and ethical conduct ~~by regulated entities~~<sup>46</sup>. Such aspirations may at times remain unfulfilled causing wider stakeholder detriment, which is difficult to repaid. Finally, an outcomes-based approach is characterised in some jurisdictions by voluntary law enforcement where the markets can be regarded as rule-makers and governance requirements act as a surrogate for statutory norms.

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<sup>45</sup> FSA, ‘Treating Customers Fairly: Towards Fair Outcomes for Consumers’, July 2006.

<sup>46</sup> J. Black and D. Rouch, ‘The development of the global markets as rule-makers: engagement and legitimacy’ (2008) 2(3) *Law and Financial Markets Review*, 223-225. See also J. Benjamin, P. Bowden and D. Rouch, ‘Law and regulation for global financial markets: markets as rule-makers – enforcement, dispute resolution and risk’ (2008) 2(4) *Law and Financial Markets Review*, 322-323; J. Benjamin and D. Rouch, ‘The international financial markets as a source of global law: the privatisation of rule-making?’ (2008) 2(2) *Law and Financial Markets Review*, 82-83.

This may be at odds with the realities of both incentives and interests<sup>47</sup>.

4. We will now discuss the practical implications of applying the above concepts. In recent years, the financial markets can be seen as the major cornerstone of the EU's strategy in terms of policy efforts. What has been achieved, ensues from the Financial Services Action Plan (FSAP)<sup>48</sup> and the numerous financial directives that the EU Institutions have adopted with a view to reforming the securities sector. A brief analysis can be made as to why the EU legislator adopted this huge financial architecture.

First, it appears that the perceived need for better regulation and consumer protection has driven the EU's strategy, also under the influence of the real integration of the markets which has occurred. Particularly, evidence of a desire to remove the existing national barriers as between Member States has marked certain directives, for example the Markets in Financial Instruments Directive (MiFID)<sup>49</sup> and the Markets in Financial Instruments Regulation (MiFIR)<sup>50</sup>, which is considered to be the centrepiece of the FSAP<sup>51</sup>. This assumption can be measured by the growing need for harmonised securities regulation; in fact, a common set of rules at international level has definitively replaced the former local rules and administrative burdens (costs of cross-border financial activities, such as permissions, licenses and authorities' approvals). The effective consequence is the adoption of shared rules and forms of "soft law"<sup>52</sup>.

Secondly, these new forms of regulation have been reflected in a self-regulation regime<sup>53</sup> characterised by internal controls, best practices, compliance and "treat customers fairly"

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<sup>47</sup> J. Crotty (note 35).

<sup>48</sup> In general terms, the FSAP was adopted by the Commission in 1999 to improve the single market in financial services. The programme is divided into four broad areas: retail markets; wholesale markets; prudential rules and supervision, and other aspects necessary to complete the financial market. Briefly, the FSAP is inserted into the 'Lamfalussy Reform', that provides a single set of rules for Member States through a complex structure of four levels (for this point, see the analysis of J. Welch, 'European Financial Services' in M. Blair QC, G. Walker (eds), *Financial Services Law*, 2006, 762.

<sup>49</sup> Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC (OJ 2004 L 145, p. 1). The Directive has been replaced by Directive 2014/65/EU (MiFID 2) (OJ 2014 L 173, p. 349).

<sup>50</sup> Regulation (EU) No 600/2014 of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Regulation (EU) No 648/2012.

<sup>51</sup> The fifth recital in the preamble to MiFID stresses that "it is necessary to establish a comprehensive regulatory regime governing the execution of transactions in financial instruments irrespective of the trading methods used to conclude those transactions so as to ensure a high quality of execution of investor transactions and to uphold the integrity and overall efficiency of the financial system".

<sup>52</sup> Soft law signifies here a form of non-binding rules constituted by legal opinions, statements, guides, protocols, and commentaries. These forms have no legal force, but can influence the Courts and market participants.

<sup>53</sup> On the significance of self-regulation regime, see J. Black, 'Decentring Regulation: Understanding the Role of Regulation and Self-Regulation in a "Post-Regulatory" World', in M.D.A. Freeman (ed), *Current Legal Problems*, 2001, Vol. 54, 112-113.

programmes<sup>54</sup>. At first glance, the complexities of the regulatory system result in fragmentation and a substantive confusion of accountability; indeed, the principles adopted to regulate the markets do not seem to operate in a clear manner. In the last few decades, rule-making has been considered to be too slow to keep up with innovation in the sphere of financial instruments (for example, in the case of derivatives) and has been relegated to the same level as principles, with the inevitable confusion of their respective roles. The former Financial Services Authority (today Financial Conduct Authority and Prudential Regulation Authority) has put greater stress on the use of principles-based regulation, while affirming that this kind of approach “means moving away from dictating through detailed prescriptive rules and supervisory actions how firms should operate their business”<sup>55</sup>.

The viable solution could lie in the compliance function as a rule of financial fairness and a form of enforcement measure. But the role of compliance must be accepted as a proper legal function, generally, by markets and, in particular, by firms; in substance, the function of compliance can be explained as an expression of self-regulation - because it is accepted by market participants - with substantive legal content<sup>56</sup>. In addition, the difference between principles and rules is to be found in the role attributed to the latter: compliance with rules is itself a form of rule, while principles represent the first stage of rule adoption. For example, principles are used to treat the market fairly with a set of best practices; compliance is used to enforce the best practices and becomes in the final analysis a rule in the sense of *jus cogens*. Firms and companies have recognised the importance of compliance, particularly as regards internal controls (the audit committee), where the relationship between administrators, managers and investors finds its best expression in a species of self-imposed rules designed to reduce the risk to the firm itself<sup>57</sup>.

Lastly, technological innovation and the transformation of the financial markets have brought about huge changes in terms of regulation, particularly in comparison between the EU and the UK strategies. On the one hand, the EU strategy has laid the foundation for a new way of dealing with the securities sector, which is characterised by consumer protection and

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<sup>54</sup> FSA (note 43).

<sup>55</sup> Financial Services Authority, ‘Principles Based Regulation: Focusing on the Outcomes that Matter’, April 2007, 4. For a critical view, see C. Conceicao and R. Gray, ‘Problems of uncertainty’ (2007) 26(6) *International Financial Law Review*, 42-43.

<sup>56</sup> D.M. Driscoll, W.M. Hoffman, J.E. Murphy, ‘Business Ethics and Compliance: What Management Is Doing and Why?’ (1998) 99(1) *Business and Society Review*, 39. It is suggested that compliance is strictly related to business ethics, in terms of good faith, due diligence and moral conduct whose aim must be to reduce the risk of bad reputation in the firms; however, to achieve this goal, corporate governance must act with responsibility, while seeking to avoid breaking the law.

<sup>57</sup> A. Newton, *The Handbook of Compliance: Making Ethics Work in Financial Services*, London, 2002, 75. The central point is that compliance represents an integral part of the internal process of controls and can contribute to limit the risk of a collapse in trust.

an investor-disclosure system<sup>58</sup>. On the other, the UK strategy has launched the ‘outcomes-based’ regime governed, not only by rules but also by principles, which have to be correctly interpreted. In this context, it is possible to observe that the connection between those two kinds of strategy can be found in the role and function of compliance: in the EU system, there is an early stage of compliance, recently revitalised in the MiFID, whilst in the UK system compliance is already extremely highly developed. However, that system of compliance provided for by MiFID would have sparse efficiency in the UK, since it is not viewed as a self-regulatory measure with legal force, but rather as an additional burden for firms<sup>59</sup>.

5. The most recent securities market reforms (the MiFID 2 in the EU system and ‘principles-based’ regulation in the UK) have constituted an important innovation in terms of regulatory approach and financial stability. However, the two systems with their different features, are still considered separately; in fact, the EU legislation - namely the ‘de Larosière’<sup>60</sup> process and the Banking Union architecture<sup>61</sup> - appears, from a UK perspective to constitute a legal obstacle to rule-making by the FCA. It has been pointed out that “the risk of principles-based regulation in the EU context is thus simply the risk of implementation of Principles at the national level moved up to the supranational level”<sup>62</sup>. Specifically, the major criticism starts from the premise that the MiFID 2 has imposed a detailed and burdensome system of rules into or on top of the UK Principles system. In contrast, the key point to stress is the fact that both systems incorporate a ‘principles-based’ regime (in the case of the EU as an instrument for harmonisation among Member States). It is possible to argue that there is a worthwhile link between the two regulatory strategies and that the EU and the UK have adopted the same framework in different institutional contexts.

The major elements are the use of self-regulation and a mixed rules-based and ‘principles-based’ regime with the compliance function acting as the enforcement measure.

Firstly, both the EU and the UK financial markets legislation adopt a form of self-regulatory approach. With the MiFID Directive, the Community legislator has introduced a set of provisions clearly characterised by voluntary conducts on the part of business (for

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<sup>58</sup> A complete and exhaustive analysis of investor protection regulation is provided by N. Moloney, *How to protect investors: lessons from the EC and the UK* (Cambridge University Press, 2010) 296-297.

<sup>59</sup> N. Moloney, ‘Effective Policy Design for the Retail Investment Services Market: Challenges and Choices Post FSAP’, in G. Ferrarini and E. Wymeersch (eds), *Investor Protection in Europe: Corporate Law Making, the MiFID and Beyond* (Oxford University Press 2006) 411-412.

<sup>60</sup> J. de Larosière, ‘The High-Level Group on Financial Supervision in the EU Report’, Brussels, February 2009.

<sup>61</sup> The design of the Banking Union has determined a transfer to the European Central Bank of the regulatory and institutional framework for safeguarding the integrity and stability of the banking and financial sectors. In particular, the Banking Union introduced a common platform for regulation of supervision; resolution mechanisms; and deposit insurance.

<sup>62</sup> J. Black, M Hopper, C. Band (note 12) 196.

instance, the suitability regime and best execution) that delegate to market participants the power of behaviour control, while the UK legislator has recently reinforced its attitude with regard to self-regulation by enhancing the mentioned ‘outcomes-oriented’ regime.

As indicated, one of MiFID’s fundamental goals is harmonisation as between Member States and the introduction of an enhanced single framework of provisions. It can be pointed out that the MiFID has created a single system for cross-border transactions with an efficient integration of securities products in which market participants are clearly accountable for their acts. In particular, the new classification of clients (i.e. retail, professional or eligible counterparty) has produced a remarkable disclosure regime, combined with a high level of consumer protection. In this way, the principles of good faith, trust and fairness are embodied in intermediaries’ behaviours. It may be noted in this context, moreover, that the investment advice having to be given to the client during the business operation can be compared to the eleven Principles for Business set out in the FCA Handbook<sup>63</sup>. In this context, the appropriateness and suitability test (MiFID, Art. 19) constitute the concrete application of best practices; consequently, the UK principles find their application in a common ground of mutual rules established by EU legislation.

Secondly, it is possible to observe that there is a relationship between the regulatory regime of MiFID and the FCA’s rule-making, since both use a mixed system of rules and principles. Closer examination prompts a number of observations: the UK regulatory system leaves to principles the power to regulate firms’ behaviours, which means that the securities market regulates itself through internal management controls and the monitoring of the FCA. In substance, the principle is regarded as a general rule, or a second level of statutory norm that deploys its legal force under the risk of misconduct and a risk of non-compliant behaviours; as a result, whereas the principle ensues from a decision by the Authority, market participants have to play an active role in ensuring that it is effective. In other words, the UK system is characterised by self-induced regulation through flexibility of principles, monitoring of management behaviours and a system of internal controls<sup>64</sup>.

In the same vein, but in a different institutional context, the MiFID establishes principles within its prescriptive provisions; the principle is inserted into the norm, thereby bringing about a mixed system where self-regulation is combined with normative regulation. For example, the conduct of business provided by Articles 19, 21 and 22 provides for the “investment advice or personal recommendations regime” and requires a set of ethical

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<sup>63</sup> See <https://www.handbook.fca.org.uk/handbook/PRIN/2/1.html>.

<sup>64</sup> R. Baldwin and J. Black, ‘Really Responsive Regulation’, *LSE Law, Society and Economy Working Papers No 15*, 2007, 3-4.



principles in order to ensure that “an investment firm acts honestly, fairly and professionally in accordance with the best interests of its clients”<sup>65</sup>; in short, the principle is at the same time a statutory norm.

Thirdly, both regimes promote the culture of compliance as an incentive to prevent risk-taking and provide legal liability, particularly, in terms of an adequate level of enforcement of principles; however, it has been argued that ‘self-induced compliance in the UK system can sometimes determine inefficiencies of enforcement in respect of misconduct’<sup>66</sup>. Whereas the institutionalised compliance provided for in the EU system acts as a form of supplementary (more stringent) enforcement, both combined with the statutory norm operate through *ad hoc* internal corporate bodies (internal audit committees). In this regard, the possible risks of compliance failures consist, on the one hand, of creative compliance (i.e. where although the spirit of the norm is adhered to, it is sometimes interpreted over-generously) and, on the other, of over-compliance (i.e. over-regulation or additional burdensome levels of enforcement).

The compliance function can be well-functioning on the basis of trust and fairness behaviours, which means confidence, transparency and cogent acts<sup>67</sup>; in other words, substantive compliance represents the key objective for fostering responsive regulation. In sum, recent financial events have shown how the UK system - albeit having a highly developed principles-based regime - has been characterised by a species of creative compliance in terms of superficial controls and according solely with the surface content of the rule<sup>68</sup>. In contrast, the EU regulatory system has developed a form of substantive compliance (according not only with the letter, but also with the spirit of the law), protected by corporate mechanisms of controls and structured within the legal platform of the MiFID. Finally, it can be argued that the implementation of the EU Directive in the UK Conduct of Business has determined an innovative change in terms of transparency and responsibility to financial consumers<sup>69</sup>.

## 6. Questions of legitimacy and accountability are linked to the utmost degree with

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<sup>65</sup> N. Moloney, ‘Financial Market Regulation in the Post-Financial Services Action Plan Era’ (2006) 55(4) *International & Comparative Law Quarterly*, 986-987.

<sup>66</sup> A.M Whittaker, ‘Better regulation – principles vs. rules’ (2006) 21(5) *Journal of International Banking Law and Regulation*, 236.

<sup>67</sup> Transparency construed as a clear understanding of roles, functions, powers and responsibility; in this sense, compliance acts as a congruent instrument for enforcing principle in conformity with the rule. See C. Diver, ‘The Optimal Precision of Administrative Rules’ (1983) 93 *Yale Law Journal*, 67-68.

<sup>68</sup> In particular, a case of non-compliant behaviours has been analysed by J. Black, R. Nobles, ‘Personal Pensions Misselling: The Causes and Lessons of Regulatory Failure’ (1998) 61(6) *The Modern Law Review*, 799-800.

<sup>69</sup> FSA, ‘Organisational Systems and Controls – A Common Platform for Firms’, CP 06/9, May 2006, 13-14.

consumer protection policy<sup>70</sup>. In this regard, the UK system has set out, in sections 3-6 of the Financial Services and Markets Act 2000 (FSMA 2000), significant regulatory objectives, such as market confidence, public awareness, consumer protection and reduction of financial crime, together with adequate consumer regulation<sup>71</sup>. Market confidence can be considered the key objective, in terms of investor protection, on account of its fundamental role of achieving soundness of the financial markets. Consequently, by avoiding the legal risks, the market reduces the risk of failures (and hence of reputational risk).

The important aspect is that of correcting imbalances of information between producers and consumers of financial services. A controversial question is whether the UK legislation affords an adequate level of consumer protection; indeed, it can be observed that, whilst on the one hand section 5(1) of FSMA 2000 ensures “an appropriate degree of protection for consumers”, on the other, section 5 (2) provides that “in considering what degree of protection may be appropriate, the Authority must have regard to (d) the general principle that consumers should take responsibility for their decisions”. In this regard, it has been observed that “an evident lack of certainty and clarity underscores the limits of the UK consumer protection system”<sup>72</sup>. By contrast, the EU legislation with MiFID has imposed a stringent assessment of investor guarantees through “the fair presentation of investment recommendations and the disclosure of conflicts of interest”<sup>73</sup>.

Broadly, legitimate and accountable regulation prevents the potential risk of confidence failure and promotes a clear understanding of consumer protection law; in this context, an innovative challenge has been set by the Office of Fair Trading, a government agency appointed to improve the consumer protection legislation through informative leaflets or booklets, guidance and publications of best practices<sup>74</sup>. The English Courts have made appreciable advances in terms of consumer protection by confirming the tendency to consider consumers as an active part of financial markets<sup>75</sup>; particularly in the banking sector, the promotion of banking codes of best practices (The Banking Code and Business Banking Code, March 2008) has demonstrated an important change in policy towards consumers.

The need for proper supervision system in the securities sector which should enhance efficient regulation by EU regulators and domestic authorities is manifest; the current

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<sup>70</sup> N. Moloney, ‘Confidence and Competence: The Conundrum of EC Capital Markets Law’ (2004) 4(1) *Journal of Corporate Law Studies*, 11-12.

<sup>71</sup> J. Fisher, J. Bewsey, M. Waters, E. Ovey, *The Law of Investor Protection* (Sweet & Maxwell, 2003) 18.

<sup>72</sup> J. Benjamin, *Financial Law* (Oxford University Press, 2007) 590.

<sup>73</sup> MiFID Directive Level 2 (2006/73/EC), recital 28.

<sup>74</sup> B. Harvey and D. Parry, *The Law of Consumer Protection and Fair Trading* (London, 2000) 50-51.

<sup>75</sup> See *Office of Fair Trading v Abbey National and others* [2009], EWCA Civ 116; the High Court stressed the question of unfair commercial practices while affirming the centrality of reasonable consumer expectations.

financial instability has underscored the existence of a complex, confused structure characterising the approach to supervision, not only at European level, but also at national level. In order better to appreciate how this could be resolved by moving towards a single financial supervisory system, fundamental developments must be taken into account.

Recently, there has been a constructive debate involving the EU institutions, scholars and commentators as to a possible approach to supervision under the Banking Union which could be capable of preventing the risk of market failures. In particular, recent proposals have shown a clear preference for establishing an integrated structure to coordinate cross-border bank supervision and resolution<sup>76</sup>. This proposal stems from past experience with different supervision models, such as the institutional model, the functional model and the integrated model<sup>77</sup>. The proposed scheme, which would have characteristics of its own, would reflect the main purposes of the supervision function: prudential supervision, ensuring the financial stability of whole securities sector and the conduct of business supervision, combined with disclosure and investor protection systems incorporated in the internal management controls<sup>78</sup>.

The financial supervision architecture is moving from an institutional and functional model towards an integrated approach where the role of national authorities is coordinated by one independent single network of financial supervisors; in this manner, a clear distribution of roles and functions between financial regulators will make for integrity and uniformity of acts<sup>79</sup>. For example, in terms of accountability, a clear division of responsibilities was set out in the ‘Memorandum of Understanding’, which allocated the different functions among the Treasury, the Bank of England and the FSA<sup>80</sup>.

Under the European Banking Union there has been a strong call for an ongoing dialogue between institutions and a constant exchange of information amongst the individual supervisory authorities. Manifestly, this objective could be achieved with an integrated supervision approach under which the supervisory function should be effective, transparent

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<sup>76</sup> The establishment of a single, unique safety net within the Banking Union would also address the ‘vicious circle’ between national governments and banks. A notable pillar of the new legislative structure is the resolvability system for bank crisis. The Bank Recovery and Resolution Directive (2014/59/EU) and the Single Resolution Mechanism (Regulation No 806/2014) aim at ensuring that failing financial institutions can be resolved in an orderly and uniform manner in the Eurozone.

<sup>77</sup> E. Wymeersch, ‘The Structure of Financial Supervision in Europe: About Single Financial Supervisors, Twin Peaks and Multiple Financial Supervisors’ (2007) 8(2) *European Business Organization Law Review*, 242-243.

<sup>78</sup> The distinction between prudential supervision and conduct of business supervision was formulated by M. Taylor, ‘Twin Peaks: A Regulatory Structure for the New Century’, Centre for the Study of Financial Innovation, London, 1995.

<sup>79</sup> C. Briault, ‘The Rationale for a Single National Financial Services Regulator’, FSA Occasional Paper Series No 2, London, 1999, 18-19; ‘Revisiting the rationale for a single financial services regulator’, FSA Occasional Paper Series No 16, London, 2002, 21-22.

<sup>80</sup> HM Treasury, Bank of England, FSA, ‘Memorandum of Understanding for Financial Stability’, March 2006.

and accountable to the political institutions. Concurrently, it has been argued that “a single financial market needs a single financial supervisor with a set of harmonised supervision powers”<sup>81</sup>. It can be cogently observed that such a supervisory solution would supply a plausible, definitive solution to the risk of monitoring loopholes and provide a response to the emergent co-operation between national supervisors and European regulators. It can also be reasonably noted that a strong improvement of risk management, together with the enforcement of internal compliant behaviours, should be implemented when tackling the new challenge of the reform of supervision. In other words, in introducing a single supervisory body it is necessary to implement continuing co-operation and coordination of functions with a permanent dialogue between national and European authorities<sup>82</sup>.

Effective reform of financial market should entail a radical change in corporate behaviours. In order to achieve this goal, a proposal for substantive compliance as a response to judgement-based and principles-based regimes may be significant in the long run.

In this way, the compliance function not only assumes a normative value, but also constitutes a useful measure for enforcing principles; in other words, substantive compliance is instituted by means of compliant management<sup>83</sup>. Logically, this new way of regulation would require responsive behaviour of market participants and would involve forms of self-enforcement; also, however, it would introduce a concept of responsible management characterised by capability and the ability to combine “the versatility and flexibility of voluntary self-regulation, avoiding many of the inherent weaknesses of voluntarism”<sup>84</sup>.

A system of internal controls represents the most important element of independence and trusteeship, which helps achieve market confidence and accountability; however, in order to promote substantive compliance there must not only be support from management but also a commitment to statutory legislation. The idea of substantive compliance, in a merit-based regime for example, does not seek to diminish the significance of the risk-based and principles-based approach, but sets out to make corporate securities participants an active part of the self-regulation decision-making process.

In order to achieve more participative regulation on the part of market actors, the compliance culture should facilitate less intrusive statutory intervention. As has been argued “governments may achieve greater compliance by engineering a regulatory system in which

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<sup>81</sup> H. Davies and D. Green, *Global Financial Regulation* (Cambridge University Press, 2008) 255-256.

<sup>82</sup> E. Ferran, ‘Capital Market Competitiveness and Enforcement’, European Corporate Governance Institute (paper produced for the City of London Corporation, 2008) 2-3.

<sup>83</sup> C. Parker and V.L. Nielsen, ‘Corporate Compliance Systems. Could They Make Any Difference?’ (2009) 41(1) *Administration & Society*, 8-9.

<sup>84</sup> I. Ayres and J. Braithwaite, *Responsive Regulation. Transcending the Deregulation Debate* (New York, Oxford University Press, 1992) 106.

they themselves play a less dominant role, facilitating the constructive regulatory participation of private interests, and relying on more or less naturally occurring regulatory orderings”<sup>85</sup>. This will entail the involvement of compliance in the formation of the self-regulation regime and in the statutory law-making process. In sum, substantive compliance necessitates the existence of a strong link between rules and principles and can be regarded as being a characteristic of self-induced regulation and enforcement in the EU and UK context. For instance, in the European securities system, compliance is provided by statutory norms (i.e. MiFID) and monitored by Community law; whilst in the UK financial structure, compliance is managed under the responsibility of senior management, on the basis of the FCA’s principles and is left to the firm’s internal controls<sup>86</sup>.

The effectiveness of internal controls can allow action to be taken against behaviours amounting to misconduct and can permit a sound system of risk management to be applied. In addition, the implementation of substantive compliance enables best practices to be incorporated into the market-based regime, which will result in a new system of governance of the securities market. It has been pointed out that “in the compliance context, new governance permits a dynamic and continually re-evaluated internal understanding of compliance”<sup>87</sup>. Principles improve voluntary norms and self-enforced behaviours and provide an incentive for the daily mechanisms of management control. Lastly, a possible path of financial reform could consist in improving effective fairness in respect of business conducts so as to reduce the reputational risk of the firm. This means better regulation<sup>88</sup> in terms of substantive compliance culture and an active role on the part of market participants.

The movement towards a risk-management culture, based on voluntary forms of regulation, has definitely changed the regulatory strategy of securities governance<sup>89</sup>. In particular, the establishment of induced moral corporate practices, under the compliance watchdog, has altered the spirit of the ‘principles-based’ regime: from ethical and formal behaviours to enforced effective norms of conduct. The successful use of principles over rules

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<sup>85</sup> P. Grabosky, ‘Using Non-Governmental Resources to Foster Regulatory Compliance’ (1995) 8(4) *Governance: An International Journal of Policy, Administration and Institutions*, 543.

<sup>86</sup> Alexopoulos and S. Linsley, ‘Senior Management Responsibilities’ (2000) 15(3) *Journal of International Banking Law*, 68-69.

<sup>87</sup> C. Ford, ‘New Governance, Compliance and Principles-Based Securities Regulation’ (2008) 45(1) *American Business Law Journal*, 28. It is argued that “a new governance-style, principles-based approach has a special relevance to firm compliance functions, meaning those policies, processes, and systems that firms themselves must have in place to prevent and detect internal wrongdoing and violations of law”.

<sup>88</sup> FSA, ‘Better Regulation Action Plan’, CP 05/10, December 2005; FSA, ‘Better Regulation Action Plan. Progress Report’, June 2006. From an academic view see R. Baldwin, ‘Is better regulation smarter regulation?’ (2005) 3 *Public Law*, 497-498.

<sup>89</sup> A. Alfieri, ‘The Fall of Legal Ethics and the Rise of Risk Management’ (2006) 94(6) *Georgetown Law Journal*, 1933-1934.

has raised an important question: how to provide an adequate enforcement measure to counter the legal risk<sup>90</sup> of a failure of internal controls. In this connection, the system of members' credibility has proved to be inefficacious for ensuring that fairness and good faith are properly applied. The role of the compliance function, as an ex ante legal measure to prevent the risks of statutory enforcement loopholes, becomes an important link between the rules-based and 'principles-based' regulatory approaches by conveying these types of regulation into the risk-based regime. A risk-based approach entails the active participation of financial members, in other words, it entails making principles more concrete<sup>91</sup>. But risk management involves compliance (regulation of internal controls) and stimulates it in terms of the effective detection of non-compliant behaviours.

The 2007-09 financial crisis has revealed all the distortions involved in managing securities products, but, at the same time, it has altered the prevailing sentiment with regard to regulation into a recognised need for a mixed regime of principles and rules. In this context, the European legislation with its normative system enshrined in the MiFID Directive has imposed a new legal platform where principles and rules coexist and the monitoring function of internal management organisations is strengthened.

7. Despite the proliferation of various headline terms such as outcomes-oriented regulation and judgement-based regulation, the underlying approach within the practice of financial regulation is a morphed version of the principles-based approach where high level principles accompany a selection (sometimes a large selection) of detailed rules. To ensure their effective co-functioning, regulated entities and regulators need to develop a better shared understanding of which stakeholders could be affected by risks and the consequences i.e. the risk-to-whom question. An outcome oriented, judgement-based approach may better lend itself to the achievement of this alongside such a principles-based regime. But first and foremost, the exercise of good judgement is tied to regulatory intentions and commitment, and sufficient resourcing of regulators. The approach that efficiencies are only gained through a reduction in regulatory burdens for firms is a convenient myth when one considers the short and longer term costs posed by the GFC.

It appears to us that at least in the UK more attention must be paid to the development of a comprehensive safety culture within financial services, rather than a supposedly pragmatic

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<sup>90</sup> A.M. Whittaker 'Lawyers as risk managers' (2003) 18(1) *Butterworth Journal of International Business and Finance Law*, 5-6.

<sup>91</sup> J. Black, 'Mapping the Contours of Contemporary Financial Services Regulation' (2002) 2(2) *Journal of Corporate Law Studies*, 278-279.

non-zero-failure approach which could easily mistakenly create the legitimacy to eschew regulations and cause stakeholder detriment on an ongoing basis. More attention must also be paid to consider the allied questions of whether and how regulators could and should address the challenges posed by regulatory arbitrage, lobbying and revolving doors, which in turn could adversely affect the scope and implementation of regulatory approaches, no matter how well-intentioned they are to begin with.